

Principles of Tax Policy

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Principles of Tax Policy

Overview

My presentation today is intended to lay out carefully the principles of tax policy and to clarify the distinction between these principles and other items

It will be clear that my views on the principles of tax policy and their interpretation differ from those of others, including NMTRI

These differences, I believe, are important aspects of the dialogue on New Mexico's tax policy that is central to the work of the Committee

I will cover four main topics:

- 1. The Principles of Tax Policy**
- 2. Tax Policy Principles and “Rules of Thumb”**
- 3. Conflicts Among Principles and Tradeoffs**
- 4. Tax Policy Principles and Tax Expenditures**

Principles of Tax Policy

The Principles of Tax Policy

There are four principles of tax policy:

- **Adequacy**
- **Efficiency**
- **Equity**
- **Simplicity**

These four principles appear, for example, on the NMTRI list and the LFC list, although other lists may phrase these principles differently

- **For example, “Equity” is often referred to as “Fairness” and “Efficiency” as “Economic Neutrality”**

Other lists may also include items in addition to the four principles

- **For example, the lists published by NMTRI and the LFC include other items**
- **The NMTRI list also includes “rules of thumb”**
- **These additional items are discussed later in the presentation**

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The Principles of Tax Policy – Cont.

What do the four principles mean?

Adequacy means that the tax system should generate sufficient revenues to pay for government spending

- **For state and local governments, this generally means that budgets should be balanced, with tax revenues equal to spending**
- **Note that the Adequacy principle does not provide any guidance on what the level or mix of government spending should be**

Efficiency means that taxes should interfere as little as possible with relative prices

- **Relative prices mean how much, for example, bread costs relative to milk, or current spending costs relative to future spending (interest rates), or labor costs relative to investment (i.e., wages relative to the user cost of capital)**

Equity has two dimensions: “horizontal” equity means that similarly situated individuals should pay similar taxes, and “vertical” equity means that individuals’ tax burdens should reflect their ability to pay

- **Note that the Equity principle applies only to individuals, who pay (bear the burden of) all taxes as consumers, workers or investors**

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The Principles of Tax Policy – Cont.

Simplicity means that taxes should be designed to minimize taxpayers' cost of complying with the tax and the cost of tax departments (like TRD) to administer the tax

- **Compliance and administrative costs are “deadweight losses” in real income in addition to the losses that result because taxes change relative prices**

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Tax Policy Principles and “Rules of Thumb”

Often the principles of tax policy are presented together with “rules of thumb” that appear to provide further guidance on the principle

These “rules of thumb” may be useful in themselves, but are not actual principles and sometimes are not fully related to, or consistent with, the four principles

I will use the “rules of thumb” from the Principles of Taxation published by NMTRI to illustrate why it is important to distinguish these rules from the actual principles of tax policy

Adequacy. The “rule of thumb” that NMTRI includes for this principle states in part, “taxes should be adequate to provide an appropriate level of those goods and services best provided by the public sector, such as education, public safety, law enforcement, streets and highways, and the courts”

- **The level and mix of spending is a key aspect of spending policy, but not of the Adequacy principle of tax policy**
- **Note also that the list of spending omits health, the second largest category of General Fund spending**

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Tax Policy Principles and “Rules of Thumb” – Cont.

Efficiency. NMTRI’s “rule of thumb” for this principle is that “tax bases should be as broad as possible so that tax rates can be as low as possible to raise the necessary revenues”

- It is true that the economic distortions due to changes in relative prices generally rise faster than tax rates, so lower tax rates are less distorting than higher tax rates
- However, it is also true that an overly broad tax base can significantly distort relative prices
- An example is the “pyramiding” in the gross receipts tax base due to taxation of sales between businesses
- The NMTRI “rule of thumb” implies that this pyramiding is desirable because it broadens the gross receipts tax base, reducing the required rate
- On the contrary, as NMTRI noted in its presentation, pyramiding is a significant tax policy issue in New Mexico

Equity. NMTRI’s “rule of thumb” for this principle is that “Businesses engaged in similar commercial activities should be subject to the same level of taxation”

- As noted previously, the Equity principle applies only to individuals; the “fairness” of business taxes is always an issue of Efficiency
- On Efficiency grounds there are circumstances in which businesses engaged in similar activities should not be taxed at the same level

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Tax Policy Principles and “Rules of Thumb” – Cont.

- **For example, production of electricity from coal-fired plants has very different environmental impacts than production from wind or solar facilities, and those differences might be reflected in different levels of taxation**
- **Another example is when differences in technology mean that similar services (like communications) are provided in different ways that benefit differentially from government spending**

The four principles of tax policy are also often presented together with other items that are not principles of tax policy

- **An example is the Accountability/Transparency item included in the LFC list of tax policy principles (NMTRI’s list contains a similar item)**
- **The item is described as follows: “Deductions, credits and exemptions should be easy to monitor and evaluate and be subject to periodic review”**
- **Tax provisions including deductions, credits and exemptions should, of course, be reviewed periodically to insure that they are consistent with the principles of tax policy (given necessary tradeoffs among principles, discussed below)**
- **But deductions, credits and exemptions are also included in the tax system to achieve purposes similar to spending programs; they are “tax expenditures”**
- **As discussed more fully below, tax expenditure provisions are not intended to determine tax liabilities and should not be evaluated by tax principles**

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Conflicts Among Principles and Tradeoffs

Inevitably, conflicts arise among the four principles of tax policy when they are used to guide tax legislation

Such conflicts require making tradeoffs among the conflicting principles

There are no objective standards for making such tradeoffs, so disagreements over the proper tradeoffs are common

The following are a few examples of such conflicts and the tradeoffs that have been made in current law:

- **To be consistent with the Efficiency principle, the gross receipts tax should apply to all (final) sales, but applying the tax to “isolated and occasional” sales would conflict with the Simplicity principle**
 - **The current statute deals with this conflict by exempting such sales (Section 7-9-29)**
- **The State personal and corporate income taxes are generally more consistent with the Simplicity principle if they conform closely to the federal taxes, which deviate in important ways from both the Equity and the Efficiency principles**
 - **The current State income taxes conform closely to most federal income tax rules**

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Conflicts Among Principles and Tradeoffs – Cont.

- **On Efficiency grounds, road user taxes would reflect the damage to roads, air pollution, and congestion caused by vehicle use, but with current technology such taxes would not be Simple, and perhaps not Equitable**
- **Current law relies primarily on motor fuel taxes as a rough proxy for road use**

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Tax Policy Principles and Tax Expenditures

Tax expenditures are designed to encourage specific forms of economic activity or to help disadvantaged individuals

The following discussion focuses on tax expenditures designed to encourage specific forms of economic activity

Since tax expenditures are paid for directly by reduced tax revenue, they appear to be in direct conflict with the Adequacy principle

These tax expenditures would seem to be in direct conflict with the Efficiency principle, because they are designed to change relative prices

Such tax expenditures also require additional record keeping and reporting by taxpayers, and additional costs for government agencies that administer the incentives, seemingly in direct conflict with the Simplicity principle

A fundamental question, therefore, is “Can tax expenditures be reconciled with the principles of tax policy?”

- **The short answer is “Yes”**
- **There is no inherent conflict between tax expenditures and tax policy principles because the tax system is merely the administrative mechanism by which the State and other governments provide tax expenditures**

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Tax Policy Principles and Tax Expenditures – Cont.

- **Tax expenditures are not intended to directly determine tax liabilities at all, which is perhaps most evident when an incentive is provided in the form of a refundable credit (for example, the high-wage jobs credit)**
- **Instead, incentive tax expenditures are purposely designed to encourage (“incentivize”) certain activities, such as making additional investments or adding jobs**
- **When such incentives are provided through the tax system, it is because the tax system is believed to be the most cost-effective method of administering the incentive**

Therefore, the principles of tax policy are not properly applied to tax expenditures; tax expenditures should be evaluated on how effectively they achieve their intended purpose

The principles for evaluating tax expenditures are not as well developed, or as widely agreed upon, as the principles of tax policy

Nonetheless, some set of principles other than tax policy principles must be used to evaluate tax expenditures

- **These principles must look to the intended purpose of the tax expenditure and provide clear guidance on how the effects of the tax expenditure can be measured against its intended purpose**